Evaluation of the Principle of "Duty of Care" In Terms of the Responsibilities of the Board Members of Corporations

■ by *Doğan Gözde ÖZGÖDEK*[*]

A Board of Directors (BD or Board), which is the management and representation body of a Corporation that is regulated by the Fourth Chapter of the Second Book of Turkish Commercial Code (TCC), is furnished with many authorizations and capabilities that could make any Corporation reputable or disreputable. Some of these authorities can be summarized as follows:

a) Representing the Corporation (Article 317)

b) Keeping the "Stockholders Plenary Committee" (PC) informed and preparing interim balance sheets, in case the financial position of the Company goes bad (Article 324)

c) Obligation of Accounting (Articles 325-326)

d) Preparation of Annual Activity Report (Article 327)

e) Employing and/or laying off workers (Article 328)

However, together with those listed above, the TCC reminds the members of a PC that they have a "duty of care" while they fulfill both these duties in particular and manage the Company in general. According to the dominant view in doctrine, "duty of care" is a principle that creates great rights and duties for the members of the PC.[1]

What does a "duty of care" mean for the BD? How is it interpreted in practice? What are the consequences?

The TCC creates the framework of the duty of care for a BD in the following basic provisions by applying the ascribed method.

---

[*] Attorney at Law, Member of Ankara Bar.

[1] Pulaşlı, *Şirketler Hukuku* (Corporate Law), Third Print, Istanbul 2001; Poroy, Tekinalp, and Çamoğlu, *Ortaklıklar ve Kooperatif Hukuku* (Corporate and Cooperative Law), Seventh Print, Istanbul 1997.

Degree of care for board members

According to Article 320, regarding the attention and foresight that the members of the Board of Directors must present in company affairs, the decree of second subclause of Article 528 in the Code of Obligations is applied.

The second subclause of Article 528, having been placed under Ordinary Company, reads as follows.

Degree of Care

Article 528 – Every partner is obliged to participate in company affairs with all his/her efforts and care as routine. He/she is obliged to cover the loses, which he/she causes to other partners with his/her mistakes, without having the right of deducting from other gains he/she has obtained on behalf of the company in other company affairs.

The partner, who manages company affairs on a salaried basis, has to be responsible as an administrator

As can be understood from these two clauses, while managing company affairs, BD members should act with exactly the care of an administrator as far as possibly can be foreseen. While not having caused any losses to the Company while directing it, they are also required to administer all necessary decisions, actions and precautions best suited to the Company's benefit.

Because of the presence of the wording "managing on salaried basis" in the referenced clause, it is also disputed in the doctrine whether Board members, who have a changing status as to whether or not they are paid or not, have different standards regarding a duty of care. How will the responsibility of a BD member be evaluated who is not paid in this aspect?

In fact, in order to be a Board member of a corporation according to the TCC, one must be a partner in the company (Article 312). Since every partner of a company obtains a certain amount of earnings or benefits from the company, including some share of the profit from the corporation or at least the possibility of those gains, I believe that it should not be disputable that the Board members have an exceptional character in terms of "collecting a salary." Considering this, there should be no basic difference between a Board member being paid a salary under the name of "honorarium" or any other name, and another member not being paid, since they all obtain some benefit from the Company.

Moreover, it is generally accepted that the "duty of care" of Board members is not of a subjective (idiosyncratic) character, but is on the contrary an objective (independent of personal matters) one.

The objective term "duty of care" is used to mean that Board members should abide as carefully and solicitously as an administrator in the similar

circumstances would.[2] Therefore, the duty of care must have a character independent of any personal matters explained above, and not have a character with personal features (that a salary is in this regard a subjective criterion).

On the other hand, the TCC describes the character of Board members' responsibilities as a "non-absolute responsibility." This emerges from the provisions of several provisions. Based on the wording and meaning of the Code, in order to hold BD members liable, they must have acted negligently. However, the TCC brings a legal presumption against Board members under Article 338.

Exclusive Clause for Liability

As Article 338 puts it, a Board member, who is shown to not be at fault in the dealings requiring joint liability according to the articles above, is not liable, particularly, if such liability is not assigned to a Board member who has voted against such dealings and had it recorded in the report of proceedings, or declared such opposition immediately to the auditors in writing, or was excused from the proceedings of such dealings.

The essence of this clause is that the damages sustained by the Company, as a result of the Board decisions, is considered to be a result of the negligent conduct of Board members, unless they prove the contrary, and Board members are assumed to be at fault.[3] The burden of proof at this point is on the Board members; it is advisable that we pay attention to this assumption in lawsuits, interpretations and expert examinations.

As can be clearly seen, the TCC has brought rather detailed assumptions stressing the concept of liability in this context. It is also important that these assumptions be applied in practice.

We should not forget that whichever Board member "conducts company affairs with regard to the duty of care" does not yield differing results for the company and particularly for closed-type corporations belonging to single capital groups. Surely, the primary responsibilities of Board members are to the company that they represent and manage; however, their responsibilities are not limited to only just that. Particularly in a company, which is a closed-type (for instance, one in which only family members constitute all the shareholders) and belongs to one capital group as we mentioned, this would not cause much effect. In such a case, "the capital belongs to that one capital group and both potential surpluses and losses will belong to this group." Then, why is it necessary to determine "whether a duty of care has been followed or not"?

In the first place, in commerce today that is not limited by national borders, and has been globalized, or at least has been regionalized, the chance of surviving is very low and exceptional for companies, which are administered

[2] Poroy, Tekinalp, and Çamoğlu, ibid, p. 311.

[3] Poroy, Tekinalp, and Çamoğlu, ibid, p. 315.

by single capital groups and are not liable to render account. Their chances of prospering are also very small. Companies generally need the collaboration of different national or foreign capital groups. They would like to promote their ability to go public; even the ones not going public increasingly need to work with different capital groups. Therefore, company administrators and Board members must have an administrative attitude in this direction; in other words, by not being accountable to themselves or to the company, they must develop an attitude of being objectively accountable in any circumstances.

Moreover, a company does not call forth rights and liabilities only for the dominant stockholders of its capital. A company is an organism that calls forth outcomes primarily for minority stockholders, and for third parties such as persons and corporations doing dealings with the company, company staff and the State. The conduct of Board members that do not pay company debts by not taking necessary precautions, and cause the downfall of the company also bring about inequitable effects that would cause third parties serious losses of rights depending on the scale and areas of activities of the company.

We have not forgotten the public shocks created just a few years ago by some bank owners who assumed the savings in their banks to be "their own money" and caused bankruptcies because of their "ill-managed" conduct. It has been suggested that this could be easily valid, even on a smaller scale, for a closed-type Small and Medium-sized Enterprise (SME) Company and its creditors, and workers.

Therefore, the duty of care of Board members, which they must strictly follow while representing and managing the Company, is important socially and legally as much as commercially.

Another importance of auditing whether the duty of care is followed or not is that, as is well known, corporation companies are liable for their debts with their own assets as equity companies.[4] In addition to this legal limitation of liability, the incorporated body of the company is taken be liable for the inequitable actions of Board members.[5]

Therefore, the positive and negative features of a director as a real person who embodies the conduct of a corporation, which is a virtual being, has been reflected exactly in the performance of the company. However, these actions which are suitable for the structure of the corporation must also not cause any losses to the third parties when the unsuccessful actions of Board members cause company performance to drop. The individual liabilities of Board members, who purposely cause losses to Company, or conduct themselves imprudently and improvidently with attitudes contradicting the obligation of objective care because of this structure of corporation, should be interpreted in a rather broad and dissuasive way.

---

[4] See Article 269.

[5] See Article 321.

In the TCC, it is accepted that company is liable, as a principal rule, for the liabilities and conducts of Board members that contradict the duty of care; however as an exception, it is possible that the aforementioned third parties (stockholders, creditors, workers, etc) may demand their losses directly from Board members.[6]

However, in practice, when direct losses are demanded, ascertaining the burden of proof as described above appears to be important. Otherwise, it will be difficult to bring forward their demands for third parties, which are not in the control of the company and of its records and/or are an outside company. To reverse the burden of proof that is set by legal presumption for lawsuits of direct losses will not make any contribution towards solving the problem, but on the contrary, will be contradicting the essence of the code.

It should be also apparent that the "Objective Bona Fide Principle" is another cross-principle which must be applied in evaluating the duty of care and in terms of direct or indirect losses of third parties and company losses caused by Board members.

Scope of judicial relations: Conscientious conduct

Article 2 - While exercising his/her rights and fulfilling his/her debts, everyone is required to abide by the rules of conscientious conduct.

A legal provision does not guarantee the blind misuse of a right.

Good will

Article 3 – In cases where the Code assesses a jurisdiction for bona fide, the essence is the presence of "bona fide."

However, depending on the condition of the case, one who does not show care as expected from him/herself cannot claim "good will".

In the first place, this rule assigns an important place to the principle that the trust of persons to the judiciary, who deal with people exercising their rights, or fulfilling their debts, must be protected**.** The main function of the "Bona Fide" rule is to draw a limit in exercising rights and fulfilling obligations, and moreover to serve largely to interpret judicial rules, particularly codes, and completing loops. Judges will also make use of these rules when creating jurisdiction or using discretionary powers.[7]

Therefore, there is an advantage in making use of the concepts of "Rule of Conscientiousness" and "Objective Good Will" in the Turkish Civil Code in order to evaluate corporate BD members in terms of liability, particularly in auditing whether an objective duty of care has been abided by or not. Company administrators who misuse the principle that a Corporation is liable within its own incorporated body and within its estates, and causing company loss, however doing it not as a fraudulent conveyance but within the Turkish

[6] Pulaşlı, ibid, pgs. 463-464

[7] Köprülü, Common Code, Istanbul, 1984, pgs.135-137

Code of Execution and Bankcruptcy Article 331 etc, and whoever doesn't act in good will -in legal and objective terms- must be directly liable and such armor shall not be a shield for them in the context of liability. This is an important point in terms of both regulations envisaged by the TCC and maintaining a public sense of justice.

Up to this point, I have tried to deal with the regulations and interpretations in the present-day TCC, predominantly regarding the principle of duty of care. However, as it has been known for some time now, there has been a bill introduced for a new Turkish Commercial Code (the Bill) in the agenda of the Turkish Grand National Assembly (TGNA). The Bill has come up as a result of that fact that the TCC, which had been enacted in 1956 based on the Commercial Code of the Federal Republic of Germany, has long been not meeting progressive needs, and also the EU Adaptation Process. The Bill, purpose of which is to re-organize Turkish commercial life under the principles of the "*Acquis Communautaire*" (Community Assets), covers important regulations in fields such as corporate governance, company transparency, and diversifying the possibilities of financial and legal auditing. Because its scope is broad and consists of major changes, I find it very useful to look at the Bill bringing new regulations that must be discussed in terms of the system of corporate board members and the duty of care principle which is our subject, although the Bill has not been enacted yet.

It is possible to summarize the 1514 clauses of the Bill as follows, with its chapters related to our subject directly.

First, let us briefly look at what functions and powers the Bill ascribes to the BDs of Corporate Companies.

Functions and powers

Article 374 – Board of Directors and the management, in its ascribed domain, excluding the ones within the power of the plenary committee in accordance with the code and the founding charter, have the power to make decisions regarding all types of matters and transactions necessary for the attainment of the company's areas of activity.

After this regulation, we see that the Bill describes some of the powers, differently from the present TCC, as powers that are personal to BD members and cannot be alienated.

Inalienable functions and powers

Article 375 – The inalienable functions and powers of a Board of Directors are as follows:

a) Top-level governance of the Company and giving guidance for governance.

b) Setting up the organizational chart.

c) Determining the principles of financial planning as needed by the accounting department, financial auditing and company management.

d) Appointment and removal of managers and others who have similar functions, and who have power to bind the Company.

e) Top supervision of the management staff, and in particular whether they act according to the laws, the founding charter, the company regulations and the written instructions of the Board of Directors.

f) Maintaining the casebook, the stock register and the proceedings of the plenary committee, preparing and presenting the annual activity reports and corporate governance comments to stockholders plenary committee, arranging plenary committee meetings and executing the decisions of the plenary committee.

g) Applying to the court in case of heavy debt.

After these two principal regulations, discussed Articles 376 and 377 have also been regularized. With this Bill, new important functions and powers are given to the Board and to its members, in particular that they should not let the economic position of the Company go bad, or that what to do when it does. For instance, "Early Diagnosis of Threats" in public companies, or what-to-do's in order to "prevent a closure and serious loss" in all types of companies; such regulations are in the Bill as new legal institutions that direct and oblige BD members to be more assiduous.

After mentioning these regulations related to functions and powers of BD members shortly, let us come to how duty of care is regulated in the Bill.

In my opinion, the most important change in the Bill is that the presumption of fault designated in Article 338 of the present Code was reversed in paragraph 3 of Article 369 in the Bill in terms of the duty of care. According to this (proposed, but changed during negotiations) regulation, the new regulation was proposed as follows.

Duty of Care and Loyalty

Article 369 (1) Members of Board of Directors and third persons, who are appointed for management, are obliged to fulfill their functions with the care of a cautious manager and to protect company interests abiding the rules of bona fide.

(2) The provisions of Articles 203 to 205 are reserved.

(3) It is the presumption that while fulfilling their functions, members and managers conduct with care in the concept of this clause.

In this case, contrary to the present regulation, when there is conduct of the Board members contrary to the duty of care and/or they are alleged to have caused losses to the Company or third parties, the burden of proof is on the one who asserts such conduct. The converse of this legal presumption is surely to be proven, but to do this the obligation will be on the assertor.

However, there is a chance of going back to the former status with the amendments in this matter, during the negotiations of the Legislature.

In the Bill, it is also clear that the provisions regarding liabilities have been summed up under a separate heading in a separate chapter. According to this, under this Chapter, these apply for not only BD members, but also for founders and liquidators, and even the persons outside company who do relevant transactions detailed liability provisions are brought. For instance:

a) Documents not being correct (Article 549)

b) False declarations on capital shares and knowledge of payment (Article 550)

c) Corruption in valuation (Article 551)

d) Collecting capital from the public without permission (Article 552)

e) General liability of Founders and Board Members together with other administrators (Article 553)

f) Liability of auditors (Article 554)

In all these articles, the cases of liabilities, some of which exist in the present Code as a primary principle, have been regulated in details. Here, in order to have a more detailed look in terms of our subject, I would like to draw your attention separately to (proposed but changed during negotiations) Article 553 of the Bill.

Liabilities of founders, members of administrative council, managers and liquidators

Article 553 - (1) Founders, members of Board of Directors, managers and liquidators are liable for the losses that they may harm the company, stockholders and creditors upon negligently contravening their obligations emanating from the Code and the founding charter.

(2) The bodies or persons alienating a function or power emanating from the Code or from the founding charter to others on a legal basis are not liable for their actions and decisions, providing that they prove that they displayed enough care while choosing those persons assigned to these functions and powers.

(3) Nobody can be held liable because of supervision and duty of care as a result of, outside of one's own control, corruption and incongruity with the Code or the founding charter.

When this article of the Bill is analyzed, BD members are still liable for the losses in case of violating their duty of care, since it is also known that the duty of care is a legal liability. However, together with the description of the inalienable powers of the BD in Article 375 of the Bill, it is a new provision before us that objective care must be present in choosing the assignee when the alienable powers are to be alienated. If it is determined that this care was not present, BD members will be liable for the actions and conduct of those persons they assigned. If they have assigned them with a suitable objective duty of care, BD members will not be liable for the decisions taken and

conduct by these persons. This is a new change in the Bill and surely if it passes into law this way, that attenuates the liabilities of the BD members. Yet, in the TCC and in the Bill, BD members are the topmost body in the making of operational decisions and the performance of the Company. That the personal assignee is an acceptable and adequate person when alienating these powers alone saves the BD member from liabilities adds a subjective element to the duty of care, which should be completely objective.

Once again, the causes absolving the liabilities ascribed in Item 3 of the same article should be accepted, in my opinion, since these causes cannot be controlled by BD members and originate from outside of Company. Otherwise, that BD member is not liable legally for corruption in Company or a contradiction to the Founding Charter because the duty of care should not absolve liabilities of the BD and its members which do not take necessary precautions to prevent complications for the Company that could occur in the scope of an objective duty of care. For this purpose, the BD must be responsible to create on one hand a healthy system of work and supervision in the Company, and on the other hand must make its working style a model with standards. For example, a BD should designate a system of work and meeting, and must conduct its business according to that schedule. Particularly when thinking about the proverb "speech vanishes, script persists," keeping the proceedings of BD meetings, and recording them should be assumed to be a part of this duty of care.

It is important to keep the proceedings of the BD, both in terms of institutionalization and protection against legal risks. Documenting the decisions of BD makes it easy to share them with top management, and therefore the execution and following-up of the decisions. In addition, the records of BD proceedings have an important place in an examination of the Company's decision-making mechanisms by stockholders, as well as by regulatory and auditing commissions and by public authorities.[8]

By the way, we should emphasize that the Code provisions find their meaning in the end only by the practitioners. By practitioners, I mean both BD members, who shall execute the provisions in the Company, and the judges and lawyers, who are expected to resolve conflicts in case one occurs. It can be observed that many provisions of the TCC today are interpreted differently or reversed by both administrative and judicial practitioners. If passed into law as is, even if it is claimed and accepted that these regulations of liabilities in the Bill will bring subjective and attenuating elements to the existing liability system, it will only be clear in practice whether this is true or not. Moreover, there is still a possibility that the Bill would be changed drastically during the negotiations in the Parliament.

While bringing, in a general sense, some new mandatory provisions and some new optional provisions, there is an incentive if not an obligation towards better corporate governance in corporate companies. The Bill attempts to rely on the principle of corporate governance in terms of the duty

[8] Yılmaz Argüden, Board of Directors' Proceeding Notes, March 2007.

of care and the liabilities of BD members. The legal basis for the Bill and the regulations, some of which I have tried to refer to above, also show this predisposition. In general, I believe the Bill will make positive contributions to commercial life and its judicial implementation.

However, I have this argument that some subjective elements, which are already in the Bill and will be passed into law, will in practice enlarge the meaning of the term duty of care, and contradict with the predisposition that I have claimed the Bill has. It would be worthwhile to amend the regulations of the Bill that will attenuate particularly the principle of joint liability concerning aggrieved parties.